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August 5, 2016

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington DC 20551

Re: Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations, Docket No. R–1538 and RIN No. 7100 AE–52[1]

Dear Mr. Frierson:

The Futures Industry Association ("**FIA**")[2] is pleased to submit this letter in connection with the rules that the Board of Governors of the Federal Reserve System ("**Board**") has proposed that would place restrictions on the terms of non-cleared qualified financial contracts ("**QFCs**")[3] to which certain U.S. banking organizations and the U.S. operations of foreign banking organizations that the Board has identified as global systemically important banking organizations ("**GSIBs**") and such GSIBs' subsidiaries (collectively, "**covered entities**") are

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1 81 Fed. Reg. 29169 (May 11, 2016).

2 FIA is the leading trade organization for the global futures, options and over-the-counter cleared derivatives markets. Its mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system and to promote high standards of professional conduct. FIA's core constituency consists of futures commission merchants ("**FCMs**"), and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA's regular members, which act as the majority clearing members of U.S. exchanges, handle more than 90 percent of the customer funds held for trading on U.S. futures exchanges. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions. FIA's regular members include 15 FCMs that are direct or indirect subsidiaries of global systemically important banking organizations.

3 A QFC is defined by reference to section 210(c)(8)(D) of Title II of the Dodd-Frank Act and includes "any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the [FDIC] determines by regulation, resolution, or order to be a qualified financial contract."

parties.[4] Our comments are limited to two issues of particular importance to FIA members: (i) the Board's decision to exclude from the restrictions of the rule those QFC's that are cleared through a central counterparty ("**CCP**"); and (ii) the Board's definition of a CCP set out at 12 CFR § 217.2.[5]

The Proposed Rules. Briefly, the proposed rules seek to improve the orderly resolution of a failed GSIB by restricting the exercise of certain default rights that would otherwise be available to QFC counterparties. Specifically, the rules would require a covered entity to ensure that any QFC to which it is party, including QFCs entered into outside the United States, provide that any default rights and restrictions on the transfer of the QFCs are limited to the same extent as they would be under Title II of the Dodd-Frank Act (Orderly Liquidation Authority) and the Federal Deposit Insurance Act. That is, the exercise of such default rights would be stayed for "the period of time beginning on the commencement of the proceeding and ending at the later of 5:00 p.m. (eastern time) on the business day following the date of the commencement of the proceeding and 48 hours after the commencement of the proceeding."[6] Further, a covered entity would be prohibited from being party to a QFC that would allow a QFC counterparty to exercise default rights against a covered entity based solely on the entry into a resolution proceeding under the Dodd-Frank Act, Federal Deposit Insurance Act, or any other resolution proceeding of an affiliate of the covered entity.[7]

The Board has proposed that the above requirements would not apply to QFCs that are cleared through a CCP.[8] In the Federal Register release accompanying the proposed rules, the Board notes that the issues the proposed rules are designed to address may exist in the context of cleared QFCs. Nonetheless, "clearing through a central counterparty also provides unique benefits to the financial system as well as unique issues related to the cancellation of cleared contracts."[9] Therefore, the Board has determined to exclude cleared QFCs, while it considers "the appropriate treatment of centrally cleared QFCs, in light of differences between cleared and non-cleared QFCs with respect to contractual arrangements, counterparty credit risk,

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4 A "covered entity" would not include certain GSIB subsidiaries that are supervised by the Office of the Comptroller of the Currency ("**OCC**"). The OCC is nonetheless expected to propose substantially similar rules governing financial institutions subject to the OCC's supervision.

5 As noted above, FCMs are FIA's core constituency. Consequently, our comments focus on the regulatory framework for cleared QFCs that are subject to the exclusive jurisdiction of the Commodity Futures Trading Commission ("**Commission**") under the Commodity Exchange Act ("**CEA**") and the Commission's rules thereunder, *i.e.*, futures contracts, options on futures contracts and cleared swaps.

6 Proposed § 252.84(h)(1).

7 Proposed § 252.84(b).

8 Proposed § 252.88(a).

9 81 Fed. Reg. 29169, 29176 (May 11, 2016).

default management, and supervision."[10] The Board invited comment on the proposed exclusion.

The comments that follow do not assume that, should the Board elect to propose rules governing cleared QFCs, such rules would be substantially identical to the current proposal for non-cleared QFCs. To the contrary, we understand the Board's comments to mean that any such rules would be tailored to account for the "unique" characteristics of the cleared transactions. Therefore, our comments will focus on the strength and benefits of the regulatory regime for cleared QFCs and makes no assumptions regarding the substance of a Board proposal.

The exclusion for cleared QFCs. FIA fully supports the Board's decision to exclude cleared QFCs from the restrictions set out in the proposed rules. Because cleared QFCs are subject to a comprehensive regulatory regime, restrictions on the terms and conditions of such QFCs may adversely affect, rather than improve, the orderly resolution of a covered entity.[11] The potential uncertainty arising from any such restrictions may result in increased costs for FCMs and their customers through increased initial margin requirements or clearing member guarantee fund requirements. Liquidity could be affected thereby, which could increase volatility.[12]

Clearing is at the heart of the Dodd-Frank financial reform, "bringing transactions and counterparties into a robust, conservative, and transparent risk management framework."[13] Since the enactment of the Dodd-Frank Act, the Commission has adopted a number of regulations designed to strengthen further this risk management framework, and reduce the risk of a default by a clearing member or a clearing member's customer.

Before turning to a discussion of the Commission's regulatory framework for cleared QFCs, we note that, under the Commission's regime, derivatives transactions are executed and cleared using the "agency model." That is, the FCM clearing member, as agent for its customer, enters into one transaction with the CCP. In the European Union, on the other hand, derivatives transactions are generally executed and cleared using the "principal-to-principal model." The clearing member enters into two separate but related transactions: (i) a principal transaction with its customer; and (ii) an equal and opposite principal transaction

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10 *Id.*

11 We appreciate that, under section 210(c)(8) of the Dodd-Frank Act, a stay may be imposed with respect to cleared QFCs. However, the authority to exercise this right should be limited as prescribed therein.

12 Moreover, many of the concerns that led to the Board's proposal simply are not present with cleared QFCs: parties to cleared QFCs face one counterparty – the CCP – rather than multiple counterparties; and cleared QFCs are margined using only cash and highly liquid securities, eliminating the fear that assets will be sold at fire sale prices.

13 Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74284, 74285, n.14 (Dec. 13, 2012).

with the CCP. We request the Board to confirm that, to the extent a CCP uses the principal-to-principal model, both legs of the transaction will be excluded from the proposed rule's restrictions.

The Regulatory Framework for CCPs. Each CCP subject to the Commission's jurisdiction must be registered with the Commission as a derivatives clearing organization ("**DCO**") and comply with the core principles for DCOs set out in section 5b of the Commodity Exchange Act ("**CEA**")[14] and Part 39 of the Commission's rules.[15] In particular, each DCO must:

- Have financial resources sufficient to cover its exposures with a high degree of confidence. In particular, the DCO must demonstrate that it has the resources to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the derivatives clearing organization in extreme but plausible market conditions.[16]
    - A systemically important DCO must maintain financial resources sufficient to enable it to meet its financial obligations to its clearing members notwithstanding a default by the two clearing members creating the largest combined loss to the DCO in extreme but plausible market conditions.[17]
- Demonstrate that it can effectively measure, monitor, and manage its liquidity risks, maintaining sufficient liquid resources such that it can, at a minimum, fulfill its cash obligations when due. Assets must be held in such a manner that the risk of loss or of delay in the DCO's access to them is minimized.[18]
- Demonstrate that it possesses the ability to manage the risks associated with discharging its responsibilities as a DCO through the use of appropriate tools and procedures. In particular, the DCO must demonstrate that, through margin requirements and other risk control mechanisms, the DCO is able to limit its exposure to potential losses from defaults by its clearing members to ensure that its operations would not be disrupted.[19]

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14 7 U.S.C. § 7a-1.

15 17 C.F.R. Part 39. These rules are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures. 17 C.F.R. § 39.40.

16 Rule 39.11(a)(1), 17 C.F.R. § 39.11(a)(1).

17 Rule 39.33(a), 17 C.F.R. § 39.33(e).

18 Rule 39.11(e), 17 C.F.R. § 39.11(e). Financial resources allocated by the DCO must be sufficiently liquid to enable the DCO to fulfill its obligations as a CCP during a one-day settlement.

19 Rule 39.13(f), 17 C.F.R. § 39.13(f).

- Demonstrate that its models will generate initial margin requirements sufficient to cover the DCO's potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin and the time within which the DCO estimates that it would be able to liquidate a defaulting clearing member's positions (liquidation time).[20]

- Collect initial margin on a gross basis for each clearing member's customer account(s).[21] Assets accepted as initial margin must be limited to those that have minimal credit, market, and liquidity risks.

- Impose risk limits on each clearing member, by house origin and by each customer origin, in order to prevent a clearing member from carrying positions for which the risk exposure exceeds a specified threshold relative to the clearing member's and/or the derivatives clearing organization's financial resources.[22]

- Conduct stress tests with respect to each large trader that poses significant risk to a clearing member or the DCO, including futures, options, and swaps cleared by the DCO, which are held by all clearing members carrying accounts for each such large trader.[23]

- Effect a settlement with each clearing member at least once each business day, and have the authority and operational capacity to effect a settlement with each clearing member on an intraday basis, either routinely, when thresholds specified by the derivatives clearing organization are breached, or in times of extreme market volatility.[24]

- Establish standards and procedures that are designed to protect and ensure the safety of funds and assets belonging to clearing members and their customers. In particular, the DCO must comply with the applicable segregation requirements of CEA section 4d and Commission regulations thereunder.[25]

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[20] Rule 39.13(g), 17 C.F.R. § 39.13(g). The minimum liquidation time must be: one day for futures and options on futures; one day for swaps on agricultural commodities, energy commodities, and metals; and five days for all other swaps. The DCO's procedures for generating initial margin requirements must be reviewed and validated by a qualified and independent party, on a regular basis.

[21] *Id.*

[22] Rule 39.13(h)(1), 17 C.F.R. § 39.13(h)(1).

[23] Rule 39.13(h)(3), 17 C.F.R. § 39.13(h)(3).

[24] Rule 39.14(b), 17 C.F.R. § 39.14(b).

[25] Rule 39.15(b), 17 C.F.R. § 39.15(b).

- Adopt default management procedures that will permit the DCO to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a default on the obligations of a clearing member to the DCO.[26]

The Regulatory Framework for FCMs. The Commission's rules governing FCMs similarly have been enhanced to reduce the risk of a default by a clearing member or a clearing member's customer by assuring that neither the clearing FCM nor any of it customers assumes financial risks beyond the risks that the FCM or customer is able to accept. In particular, each FCM that is a clearing member of a DCO must:

- Establish, maintain, and enforce a system of risk management policies and procedures, which must approved in writing by the FCM's governing body, designed to monitor and manage the risks associated with the FCM's activities as such.[27]
    - The policies and procedures must: (i) take into account market, credit, liquidity, foreign currency, legal, operational, settlement, segregation, technological, capital, and any other applicable risks together with a description of the risk tolerance limits set by the FCM and the underlying methodology in the written policies and procedures; and (ii) be reasonably designed to ensure that segregated funds are separately accounted for and segregated or secured as belonging to customers as required by the CEA and the Commission's rules.
- Establish a targeted amount of residual interest that the FCM seeks to maintain as its residual interest in the customer segregated funds accounts, which is designed to reasonably ensure that the FCM maintains the targeted residual amounts and remains in compliance with the segregated funds requirements at all times.[28]
- Establish policies and procedures for assessing the liquidity, marketability and mark-to-market valuation of all securities or other non-cash assets held as segregated funds, to ensure that all non-cash assets held in the customer segregated accounts are readily marketable and highly liquid.[29]

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[26] Rule 39.16(c), 17 C.F.R. § 39.16(c). Actions that the DCO may take upon a default must include the prompt transfer, liquidation, or hedging of the customer or house positions of the defaulting clearing member, as applicable and, in the discretion of the DCO, the auctioning or allocation of such positions to other clearing members.

[27] Rule 1.11(c), 17 C.F.R. § 1.11(c). The policies and procedures must take into account market, credit, liquidity, foreign currency, legal, operational, settlement, segregation, technological, capital, and any other applicable risks together with a description of the risk tolerance limits set by the FCM and the underlying methodology in the written policies and procedures.

[28] Rule 1.11(e), 17 C.F.R. § 1.11(e).

[29] *Id.*

- Establish risk-based limits in the proprietary account and in each customer account carried by the FCM based on position size, order size, margin requirements, or similar factors, and screen orders for compliance with such limits.[30]

- Coordinate with each DCO on which it clears to establish systems that enable the FCM, or the DCO acting on its behalf, to accept or reject each trade submitted to the DCO for clearing by or for the FCM or a customer of the FCM as quickly as would be technologically practicable.[31]

The Bankruptcy Code. Although the above provisions of the Commission's rules substantially reduce the risk that an FCM clearing member, or a clearing member's customer, will default in its payment obligations to the DCO, in the unlikely event of an FCM's insolvency, Subchapter IV of Chapter 7 of the Bankruptcy Code ("**Code**") establishes a comprehensive regime for the liquidation of an insolvent FCM.[32] Congress has vested the Commission with authority to oversee the liquidation of an FCM[33] and, further, to adopt rules to supplement the Subchapter IV of the Code to provide, *inter alia*, the "method by which the business of such commodity broker [*i.e.*, an FCM,] is to be conducted or liquidated after the date of the filing of the petition under such chapter, including the payment and allocation of margin with respect to commodity contracts not specifically identifiable to a particular customer pending their orderly liquidation."[34]

The Commission's Part 190 rules provide detailed instructions by which the trustee in bankruptcy must conduct and liquidate the business of the FCM.[35] Significantly, although the Commission's rules do not expressly affect the right of a DCO under the Code "to cause the liquidation, termination, or acceleration of a commodity contract,"[36] Commission Rule

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30 Rule 1.73(a), 17 C.F.R. § 1.73(a).

31 Rule 1.74(a), 17 C.F.R. § 1.74(a).

32 We note that each of the FCMs that is an affiliate of a GSIB is also registered with the Securities and Exchange Commission as a broker-dealer. An insolvent FCM that is also a registered broker-dealer is likely to be liquidated under the provisions of the Securities Investor Protection Act ("**SIPA**") rather than the Code. Nonetheless, the provisions of Subchapter IV of Chapter 7 of the Code and Part 190 of the Commission's rules should apply. SIPA provides that "[t]o the extent consistent with the provisions of this chapter or as otherwise ordered by the court, a trustee shall be subject to the same duties as a trustee in a case under chapter 7 of title 11, including, if the debtor is a commodity broker, . . . the duties specified in subchapter IV of such chapter 7." 15 U.S.C. § 78fff-1(b).

33 "The Commission may raise and may appear and be heard on any issue in a case under this chapter." 11 U.S.C. § 762(a).

34 CEA Section 20(a)(3), 7 U.S.C. § 23(a)(3).

35 Under the Code, an insolvent FCM must be liquidated. Reorganization under Chapter 11 of the Code is not available to an FCM.

36 Code Section 561, 11 U.S.C. § 561.

190.02(e) requires the trustee to "immediately use its best efforts" to effect a transfer of all customer accounts.[37]

The Commission's rules reflect the understanding that it is in the best interests of all parties – the insolvent FCM, its customers, the DCO and the remaining DCO clearing members – if the positions of non-defaulting customers are transferred to a solvent clearing member. Nonetheless, it is also understood that a DCO must have the flexibility to liquidate the positions of an insolvent clearing member and, if necessary, such FCM's customers, if the DCO determines that the prompt liquidation of such positions is essential to avoid disruption of the markets.

The failure of one clearing member, or such clearing member's customer, may not be permitted to threaten the solvency of the remaining non-defaulting clearing members. If liquidation of a defaulting clearing member's positions is necessary to assure that required margin payments are made to non-defaulting clearing members or to reduce unnecessary volatility in the markets, the DCO should not be prohibited from exercising this right.[38] Similarly, the right of a clearing member to liquidate the open positions of a defaulting customer, thereby reducing the clearing member's risk of incurring greater loss, should not be delayed. Such delay, either at the DCO level or at the clearing member level unnecessarily introduces systemic risk with potentially significant adverse financial consequences for non-defaulting clearing members and non-defaulting customers of all clearing members.

The Definition of a CCP. Although the Board did not request comment on its definition of the term "central counterparty" set out at 12 CFR § 217.2, which it adopted in 2013,[39] we nonetheless encourage the Board to consider proposing a revised definition. At least insofar as that term is applied to QFCs cleared through a CCP, we believe the definition inadequately describes the legal relationship between a CCP and the original QFC counterparties.

As defined at 12 CFR § 217.2, a "CCP" is "a counterparty (for example, a clearing house) that facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts." However, a CCP does far more than simply "facilitate" or "guarantee" trades between counterparties. Rather, a CCP through novation or otherwise, "interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and

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37 Rule 190.02(e), 17 C.F.R. § 190.02(e).

38 We further note that a DCO's conduct in such circumstances would be governed by the DCO's default management procedures that must be designed to permit the DCO to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a default on the payment obligations of a clearing member to the DCO. Such procedures have either been approved by, or self-certified to, the Commission (and not disapproved). *See* Rule 40.6, 17 C.F.R. § 40.6.

39 78 Fed. Reg. 62018 (Oct. 11, 2013).

thereby ensuring the performance of open contracts."[40] Further, a CCP provides for the settlement or netting of obligations among counterparties on a multilateral basis.

Although the concepts above may be subsumed in the Board's current definition, we respectfully recommend that the Board adopt a more rigorous definition of a CCP, which provides a more complete description of the legal relationship among the parties and the legal consequences of a cleared QFC. We, therefore, suggest the following definition for the Board's consideration, which is based, in substantial part, on the definition of a derivatives clearing organization in section 1a(15) of the CEA:[41]

> **Central counterparty (CCP)** means an entity (for example, a clearinghouse or similar facility, system, or organization) that, with respect to an agreement, contract, or transaction: (i) enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the CCP for the credit of the parties; and (ii) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the CCP.

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Because cleared QFCs are subject to a comprehensive regulatory regime, as described in detail above, we respectfully submit that restrictions on the terms and conditions of cleared QFCs may adversely affect, rather than improve, the orderly resolution of a covered entity. FIA, therefore, supports the Board's decision to exclude cleared QFCs from the proposed rules. If the Board nonetheless elects to propose rules that would impose restrictions on the terms and conditions of cleared QFCs, we ask the Board to propose concurrently a revised definition of the term "central counterparty".

FIA appreciates the opportunity to submit these comments for the Board's consideration. If the Board or any member of its staff has any questions regarding the matters discussed herein, please contact Allison P. Lurton, Senior Vice President and General Counsel, at 202.466.5460 or alurton@fia.org.

Sincerely,

Walt L. Lukken

Walt L. Lukken
President and CEO

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40 *Principles for Financial Market Infrastructures* (April 2012), published by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions ("**CPSS-IOSCO**"), p. 9.

41 7 U.S.C. § 1a(15).